

Letter of Findings: 04-20150544
Gross Retail and Use Tax
For the Years 2010, 2011, and 2012

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

Medical Device Manufacturer was entitled to an adjustment of an assessment of additional sales tax based on the purchase of exempt items used in the production of its medical products; the Department's audit division was requested to review invoices for the purchase of exempt electric utilities and to allow a credit not to exceed the amount of the audit assessment.

ISSUES

I. Gross Retail and Use Tax - Exempt Purchases.

Authority: IC § 6-2.5-1-2; IC § 6-2.5-2-1(a); IC § 6-2.5-2-1(b); IC § 6-2.5-3-1(a); IC § 6-2.5-3-2(a); IC § 6-2.5-4-1(b); IC § 6-2.5-5-2(a); IC § 6-2.5-5-3; IC § 6-2.5-5-3(b); IC § 6-2.2-5-5.1; IC § 6-8.1-3-12(b); IC § 6-8.1-5-1(c); Dept. of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579 (Ind. 2014); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Rhoades v. Indiana Dep't of State Revenue, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); USAir, Inc. v. Indiana Dep't of State Revenue, 623 N.E.2d 466 (Ind. Tax Ct. 1993); General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991); Indiana Dept. of State Rev. v. Kimball Int'l Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988); Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974); [45 IAC 2.2-5-8](#); [45 IAC 2.2-5-8\(a\)](#); [45 IAC 2.2-5-8\(c\)](#); [45 IAC 2.2-5-8\(d\)](#); [45 IAC 2.2-5-8\(f\)\(3\)](#); [45 IAC 2.2-5-8\(g\)](#); [45 IAC 2.2-5-8\(i\)](#); [45 IAC 2.2-5-8\(k\)](#); [45 IAC 2.2-5-9](#).

Taxpayer argues that the Department's sales tax audit failed to consider overpayments of tax when calculating the amount of sales and use tax assessed during that audit.

STATEMENT OF FACTS

Taxpayer is an out-of-state company in the business of manufacturing, selling, and distributing orthopedic equipment. Taxpayer's products include instruments for hip and knee replacement procedures, trauma injuries, and spinal medical procedures. Taxpayer operates research, design, and manufacturing facilities located in Indiana.

The Indiana Department of Revenue ("Department") conducted a sales and use tax audit review of Taxpayer's business records and tax returns.

The Department's audit resulted in the assessment of additional sales and use tax. Taxpayer disagreed with the assessment and submitted a protest to that effect. An administrative hearing was conducted by telephone during which Taxpayer's representative explained the basis for the protest. This Letter of Findings results.

I. Gross Retail and Use Tax - Exempt Purchases.

DISCUSSION

Taxpayer disagrees with the assessment on the ground that the Department's audit was flawed in assessing tax where none was due and failing to give "credit" for amounts of tax paid on the purchase of exempt equipment and supplies.

A. Audit Results.

The audit reviewed Taxpayer's sales of medical equipment to distributors and manufacturers which claimed an exemption when the purchases were made. In addition, the audit reviewed Taxpayer's own purchases of "tangible personal property" for use at their Indiana facilities.

Taxpayer signed a use tax "Agreement for Projecting Audit Results" dated December 4, 2014, "in lieu of actual figures" The signed agreement included a "sample design" detailing the methodology to be used in conducting the sample and projecting the results.

The audit conducted a statistical sampling of Taxpayer's purchase records. The audit randomly selected 1,249 invoices from 16,444 charges during the audit period. The 1,249 invoices were categorized as: (1) "additional tax liability"; (2) "not taxable"; (3) "use tax accrued"; (4) "sales tax paid"; and (5) "no record provided."

The audit found that Taxpayer failed to pay tax as follows:

Additional taxable tangible personal property includes production department supplies which are not used directly in direct production and therefore not granted an exemption from sales and use tax. Examples include batteries, gloves, metal cabinet, drawers, socket set, tool car. Taxable purchases also include landscape materials, parking lot salt, lockers, racks, bins, and furniture which are not afforded an exemption from retail sales tax.

B. Taxpayer's Response.

Taxpayer disagrees with the assessment on various grounds. Taxpayer states that the Department's audit failed to provide Taxpayer an opportunity to provide information regarding purported overpayments of tax it paid on "purchases of machinery, equipment, tools, supplies and utilities used in manufacturing or production at their facilities in [Indiana municipality] and [second Indiana municipality]."

In addition, Taxpayer criticizes the sampling methodology employed during the Department's audit. Taxpayer states "there were no sales and use tax overpayments identified in the statistical sample that was used by the Department of Revenue to project additional taxable purchases for the audit" Taxpayer further explains that "it [is] highly unlikely that there were no instances where sales tax was paid in error, on any of the over one-thousand invoices reviewed by the auditors as part of their statistical sample."

Finally, Taxpayer "believes it was not given the opportunity to respond to the sample errors included in the projection in a timely manner before the proposed assessments were issued by the Department."

Taxpayer argues that it purchased items used in its business which qualify for an exemption, that tax was paid on the items for which it now deserves a "credit," or that the audit included items in the sample which should have been categorized as exempt.

C. Hearing Analysis.

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Consequently, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Further, "[W]hen [courts] examine a statute that an agency is 'charged with enforcing . . . [courts] defer to the agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party.'" *Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014). Thus, interpretations of Indiana tax law contained within this decision, as well as the preceding audit, are entitled to deference.

Indiana imposes an excise tax called "the state gross retail tax" (or "sales tax") on retail transactions made in Indiana. IC § 6-2.5-2-1(a). A person who acquires property in a retail transaction (a "retail purchaser") is liable for the sales tax on the transaction. IC § 6-2.5-2-1(b).

Indiana also imposes a complementary excise tax called "the use tax" on "the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location

of that transaction or of the retail merchant making that transaction." IC § 6-2.5-3-2(a). Use means the "exercise of any right or power of ownership over tangible personal property." IC § 6-2.5-3-1(a). The use tax is functionally equivalent to the sales tax. See *Rhoades v. Indiana Dep't of State Revenue*, 774 N.E.2d 1044, 1047 (Ind. Tax Ct. 2002).

By complementing the sales tax, the use tax ensures that non-exempt retail transactions (particularly out-of-state retail transactions) that escape sales tax liability are nevertheless taxed. *Id.* at 1048; *USAir, Inc. v. Indiana Dep't of State Revenue*, 623 N.E.2d 466, 469 (Ind. Tax Ct. 1993). The use tax ensures that, after such goods arrive in Indiana, the retail purchasers of the goods bear their fair share of the tax burden. To trigger imposition of Indiana's use tax, tangible personal property must (as a threshold matter) be acquired in a retail transaction. IC § 6-2.5-5-2(a). A taxable retail transaction occurs when; (1) a party acquires tangible personal property as part of its ordinary business for the purpose of reselling the property; (2) that property is then exchanged between parties for consideration; and (3) the property is used in Indiana. See IC § 6-2.5-1-2; IC § 6-2.5-4-1(b), IC § 6-2.5-3-2(a).

It should be noted that the audit acted within its authority to conduct a "statistical sampling" of Taxpayer's transactions and to propose an assessment based on that sampling. The authority to do so is found at IC § 6-8.1-3-12(b) which states:

The department may audit any returns with respect to the listed taxes using statistical sampling. If the taxpayer and the department agree to a sampling method to be used, the sampling method is binding on the taxpayer and the department in determining the total amount of additional tax due or amounts to be refunded. (Emphasis added).

1. Equipment Used in Direct Production of Taxpayer's Orthopedic Instruments.

Taxpayer is in the business of manufacturing orthopedic instruments. The general rule is that all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly or finishing of tangible personal property - such as Taxpayer's orthopedic instruments - are taxable. [45 IAC 2.2-5-8\(a\)](#).

However, as authority for its conclusion that certain of its equipment is exempt, Taxpayer cites to the Indiana statute, IC § 6-2.5-5-3, which states in part:

(b) Except as provided in subsection (c), transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

(c) The exemption provided in subsection (b) does not apply to transactions involving distribution equipment or transmission equipment acquired by a public utility engaged in generating electricity.

The Department's regulation, [45 IAC 2.2-5-8](#), explains that a taxpayer is entitled to purchase machinery, tools, and equipment without payment of the gross retail tax when the equipment is used in the direct production of tangible personal property. [45 IAC 2.2-5-8\(a\)](#) emphasizes that the exemption is limited to that equipment "directly used by the purchaser in direct production." [45 IAC 2.2-5-8\(c\)](#) specifies that "directly used" means that the equipment has "an immediate effect on the article being produced." Refining the definition further, the regulation states that "[p]roperty has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property." *Id.* See IC § 6-2.5-5-3(b). However, it should also be noted that "[t]he fact that particular property may be considered essential to the conduct of the business of manufacturing because its use is required . . . by practical necessity does not mean that the property 'has an immediate effect upon the article being produced.'" [45 IAC 2.2-5-8\(g\)](#).

Finally, [45 IAC 2.2-5-8\(k\)](#) specifies that, in order to qualify for the exemption, the articles being produced have undergone a "substantial change."

"Direct production, manufacture, fabrication, assembly, or finishing of tangible personal property" is performance as a business of an integrated series of operations which places tangible personal property in a form, composition, or character different from that in which it was acquired. The change in form, composition, or character must be a substantial change, and it must result in a transformation of property into a different product having a distinctive name, character, and use. Operations such as compounding, fabricating, or assembling are illustrative of the types of operations which may qualify under this definition.

Proper application of this particular exemption requires determining at what point "production" begins and at what point "production" ends. In part [45 IAC 2.2-5-8\(d\)](#) states:

Pre-production and post-production activities. "Direct use in the production process" begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required.

To summarize, machinery, tools, and equipment purchased for use in the production of goods are subject to use tax unless the item has a direct and immediate effect on the goods produced, falls within the actual production process, and is essential to an integrated process used to produce those marketable goods.

In addition to establishing that any portion of the assessment was wrong, Taxpayer has the burden of establishing that it is entitled to the sought after exemption. In applying any tax exemption, the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." *Indiana Dept. of State Rev. v. Kimball Int'l Inc.*, 520 N.E.2d 454, 456 (Ind. Ct. App. 1988). A statute which provides a tax exemption, however is strictly construed against the taxpayer. *Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96, 97 (Ind. Ct. App. 1974). "[W]here such an exemption is claimed, the party claiming the same must show a case, by sufficient evidence, which is clearly within the exact letter of the law." *Id.* at 101 (citing *Conklin v. Town of Cambridge City*, 58 Ind. 130, 133 (1877)).

Nevertheless, the Department is well aware of the countervailing rule that a "statute must not be construed so narrowly that it does not give effect to legislative intent because the intent of the legislature embodied in a statute constitutes the law." *General Motors Corp. v. Indiana Dept. of State Revenue*, 578 N.E.2d 399, 404 (Ind. Tax Ct. 1991).

The issue is whether the specific items of Taxpayer's equipment, supplies, or materials are exempt because these items are directly used in the production process because they have an "immediate effect on the article being produced." [45 IAC 2.2-5-8\(g\)](#).

Taxpayer purchased from a company called "R&D Wire" ten machine electrodes. Taxpayer states that the purchase should have been categorized within the sample as "exempt" because the electrodes are directly used to produce Taxpayer's medical instruments. However, Taxpayer has provided nothing which enables the Department to arrive at such a conclusion. The electrodes may very well be exempt or not be exempt; the electrodes may well be used before or after the direct production of the instruments.

Taxpayer purchased from "Raptor Workhold Products" an "Aluminum Dovetail Fixture" which Taxpayer describes as a "fixture to hold production parts." Taxpayer has provided no other details which would allow a conclusion that the fixture is directly used in the direct production of Taxpayer's medical instruments. The fixture may well be essential to the production of the instruments but as [45 IAC 2.2-5-8\(g\)](#) states "[t]he fact that particular property may be considered essential to the conduct of the business of manufacturing because its use is required . . . by practical necessity does not mean that the property 'has an immediate effect upon the article being produced.'"

Taxpayer purchased from "TRUMPF Inc." items called a "Pallet Cart Loading" and an "Unpacking Table." Taxpayer explains that these two devices are used to hold medical instruments within the production process. Taxpayer explains that the two items are exempt because they are "integral" to the production of the medical instruments. Taxpayer offers a more detailed explanation of these two items.

The pallet carts and unloading system are an integral part of the machine and are all connected together. We have 3 pallet carts which we load material [unto]. The machine picks the material up from the pallet carts and places it [unto] the laser cutting platform. When finished, the unloading system automatically picks up the laser cut piece and off loads it while simultaneously picking up another sheet of material from the pallet carts and the whole cycle starts again.

Based on Taxpayer's explanation of these two items, the Department agrees that the items are exempt because they fall within the production process and have an immediate effect on the items being produced. As explained in [45 IAC 2.2-5-8\(f\)\(3\)](#):

Transportation equipment used to transport work-in-process or semi-finished materials to or from storage is not subject to tax if the transportation is within the production process.

Taxpayer purchased from a company called "Meredith Machinery" various items for which the documentation establishes Taxpayer paid Indiana sales tax. Taxpayer states that these items are "Parts for Production Equip." In this case, Taxpayer's description and the accompanying documentation are sufficient to establish that the items purchased were directly involved in the production of Taxpayer's medical instruments.

Taxpayer purchased a floor scale from a company called "Antibus Scales & Systems." Taxpayer argues it was not required to pay Indiana sales tax on the purchase of the scale because the scale is production equipment used to control the quality of the medical instruments. [45 IAC 2.2-5-8](#) provides guidance on this issue in the form of an example.

Selected parts are removed from production according to a schedule dictated by statistical sampling methods. Quality control equipment is used to test the parts in a room in the plant separate from the production line. Because of the functional interrelationship between the testing equipment and the machinery on the production line and because of the product flow, the testing equipment is an integral part of the integrated production process and is exempt. [45 IAC 2.2-5-8\(i\)](#).

Assuming for the moment that the floor scale does what Taxpayer claims it does, there is no information which establishes that the testing or quality control process is "integral" with the production of the medical devices. Therefore it is not possible to conclude that the scale is exempt.

Taxpayer paid money to a company called "CAD/CAM Technologies." Taxpayer states that it was paying for software maintenance agreements. The agreements were intended to maintain and/or update computer software used to operate Taxpayer's milling machines. In this case, Taxpayer has provided sufficiently detailed information to establish that the milling machines are "directly" used to produce Taxpayer's medical devices and the software is used to control the milling machines. Since the maintenance agreements affect and control the software and the software is used to drive the milling machines, the Department agrees that the maintenance agreements are not subject to sales tax.

2. Taxes Paid.

Taxpayer purchased non-exempt items from a company called "Workspace Solutions." The audit included this transaction in its sample of invoices and assessed sales tax. Taxpayer has provided documentation establishing that sales tax was paid at the time of the original transaction.

3. Exempt Utilities.

Following the issuance of the audit report and proposed assessments, Taxpayer obtained from the Department a form ST-109 (Indiana Utility/Communications Sales tax Exemption Certificate"). The form is intended to verify that purchases of "tangible personal property" directly used by the certificate holder are directly used in the direct production of tangible personal property pursuant to IC § 6-2.2-5-5.1. Under that statute, electricity is designated as "tangible personal property" entitled to the exemption.

Taxpayer provided utility invoices paid during the years under audit. Taxpayer has asked that the invoices be reviewed by the Department and a "credit" be allowed for tax paid on purportedly exempt utilities.

This Letter of Findings takes no position on whether or not Taxpayer is entitled to the requested "credit." Instead, the Department's audit division is requested to review the invoices and to make whatever adjustment is warranted based on the documentation provided.

FINDING

Taxpayer's protest is sustained in part and denied in part.

SUMMARY

As described, Taxpayer is entitled to an adjustment of the assessment because some of the sales transactions were exempt or because tax was paid at the time of the original transaction. The Department's Enforcement Division is requested to review the utility invoices and to allow a credit up to - but not to exceed - the amount of the audit assessment.

